

REPORT TO THE SECRETARY OF THE TREASURY
FROM THE
TREASURY BORROWING ADVISORY COMMITTEE
OF THE
SECURITIES INDUSTRY AND
FINANCIAL MARKETS ASSOCIATION

April 29, 2008

Dear Mr. Secretary:

Since the Committee's previous meeting in late January, credit conditions have remained stringent and the economy has weakened. Overall, Federal Reserve policies have proved effective in forestalling a financial market crisis by effectively eliminating the possibility of another bank failure but concerns remain about the appropriate quoting of money markets rates, term financing and continued proper functioning of the money markets in the absence of these Fed programs. Expectations for economic growth in the first half of 2008 have continued to fall and a number of primary dealers judge the economy currently to be in recession. Housing remains a notable drag through a variety of channels and that weakness now is being augmented by a more cautious approach to spending by businesses and consumers. Forthcoming tax rebates likely will boost consumer spending in the months ahead but that lift will be temporary. On balance, the outlook for the economy will remain uncertain until credit conditions improve and financial intermediation begins to function more smoothly.

Inflation has remained somewhat elevated due to ongoing price increases for food and energy. Slowing economic growth has had a moderating effect on an array of other consumer prices, especially for credit-sensitive goods such as motor vehicles and household durables. Core consumer prices are increasing in a 2% to 2-1/2% range. Chances favor some improvement in these measures amid tight financial conditions, softer home prices and higher unemployment. Nonetheless, rising food and energy costs' possible effect on inflation expectations may sustain concerns about inflationary pressures.

The steady tightening in financial conditions has led the Federal Reserve to lower the federal funds target rate to 2-1/4%. Futures markets anticipate another quarter-point reduction in the policy rate, followed by a period of stability. The shift in investor expectations for the path of monetary policy has contributed to the recent rise in market interest rates and the flattening of the U.S. Treasury yield curve.

The Federal government's budget balance is deteriorating in fiscal year 2008. Weaker economic activity has dampened the pace of revenue collection and lifted growth in economically sensitive spending. A recent survey of primary dealers estimates that the deficit for the 2008 fiscal year ending in September will exceed \$400 billion with some economists expecting a deficit of more than \$500 billion—a significant deterioration from fiscal 2007's deficit of \$163 billion. Economic stimulus measures will complement the forces widening the budget deficit. This year's shortfall may surpass fiscal year 2004 as the largest on record in nominal dollars.

In its first charge to the Committee, the Treasury solicited our advice and recommendations for Treasury issuance over the near and intermediate term given the aforementioned deterioration in the fiscal budget outlook.

As a near-term solution, there was universal agreement on the Committee that the Treasury should introduce a 52-week bill to its auction schedule. A "year bill" would reduce the Treasury's reliance on large cash management bills and provide sufficient financing to absorb the increased borrowing needs that have grown so quickly over the last year.

There was also universal agreement on the Committee that the Treasury needs to prepare for additional financing needs over a more intermediate term. In fact, several members argued that the current deterioration in the fiscal outlook might be more than temporary and that the risk of further deterioration outweighs the risk of a surprise improvement in the deficit.

Furthermore, additional members again reiterated their concern that this latest "cyclical" deterioration in the fiscal outlook is particularly troublesome as the longer-term "secular" forces of entitlement spending and the aging of the baby boom generation and their effect on the budget deficit are no longer that distant in the future.

Consequently, there was strong agreement on the Committee that the Treasury consider altering its issuance calendar over the intermediate term to account for these forces.

The Committee recommends that the Treasury review its issuance calendar and increase the size and the frequency of existing coupon issuance over the coming quarters in addition to the near-term solution of adding a year bill. Several members noted that the increased reliance on Treasury bills, as the deficit has deteriorated, has shortened the average maturity of the debt, and that steps should be taken to arrest this trend, if not, to purposefully reverse it.

The majority of members believe that the addition of the year bill combined with increases to the size and frequency of existing coupon debt over coming quarters will still not be sufficient to satisfy the increased financing needs of the Treasury over the intermediate and longer term.

Consequently, most members recommended that the Treasury prepare the markets for a re-introduction of a coupon note over the coming quarters. The Committee was somewhat divided as to the maturity of such a note. A 3-year note was suggested by some given its relative ease of issuance, while longer-dated notes were suggested by others who are concerned with the shrinking of the average maturity of the debt as argued above.

In any event, the Committee was in strong agreement that the Treasury cannot view the deterioration in the fiscal deficit as “temporary” and must plan for increased flexibility of bills and notes over coming quarters to ensure a continued effective financing environment.

In the second charge, the Committee was asked to address the prevailing low interest rate environment’s potential impact on an increase in systemic fails in the Treasury market. The consequences of such fails would be an impairment of liquidity and an increased cost to Treasury borrowing. Consequently, the Treasury has encouraged market participants to discuss and pursue market-oriented solutions to ease this potential burden.

The discussion was accompanied by a chart that depicted tangible spikes in fail activity during the low rate periods of 2001, 2003 into 2004, and the recent fail rate increases over the past few months, as rates have once again declined precipitously.

The presentation suggested that a number of private sector participants, including the Securities Industry and Financial Markets Association Group (SIFMA) and the Treasury Market Practices Group (TMPG), were encouraging some actionable steps towards dealing with this issue. A few of the Borrowing Committee members actually sit on one or more of these industry groups and suggested that their work was yielding some positive results.

One of these suggestions was in the form of a prompt delivery trading practice or buy-in mechanism. A couple of Committee members suggested that while these measures would enhance clarity and boundaries for market participants, they would also encourage arbitrage, and increased market activity around these rules or guidelines. However, the notes from the presentation did suggest that there was a broad consensus around encouraging a cash settlement of fails before the 30th day after the fail had occurred.

There was also some discussion of a negative rate repo trading practice, which had some support, due to its ability to allow the marketplace to source securities at a price that would guarantee delivery. SIFMA has formed a task force to study this and related issues.

There was general consensus among committee members that a well-defined series of “Fails Best Practices” outlined by SIFMA and TMPG, which defined such parameters as margining of fails, cash settlement procedures, and initiatives related to pair-offs and security-delivery, would be extremely beneficial.

To supplement this “Best Practices” set of procedures, the Committee was supportive of a Treasury Fails Monitoring Committee that would be comprised of senior funding and cash market participants. This committee would be established to assess market conditions in this arena, make those issues transparent to the broader market, and recommend practices aimed at dealing with the issues if they became outside the bounds of normal market activity.

This Fails Monitoring Committee, alongside of traditional Treasury Department surveillance, and potentially increased Treasury position disclosure (although some suggested that this could have harmful market-effects), should provide for the ability to monitor and influence appropriate market behavior.

The majority of the Committee feels as if subtle activity by the Treasury such as moral suasion, timely reporting of abnormal market activity, and otherwise regular market surveillance, will also help provide for efficient and normal market conditions to exist.

The Committee suggested that continued review and assessment of these issues would be beneficial in the near future, as it would appear that the market will be in for a more sustained low interest rate environment.

In its third charge to the Committee, the Treasury asked for our views of recent initiatives taken by public and private entities to address the problems in the U.S. housing sector.

Committee members were in agreement that the problems in the housing market were significant, and many were concerned that without intervention the problems would grow worse. In fact, housing price data from S&P/Case-Shiller was released hours before our meeting and highlighted that the decline in housing prices is not over but that prices are actually accelerating to the downside. For example, while year-over-year prices were reported to be down almost 13%, prices on a 6-month, 3-month and 1-month basis have declined 21%, 25% and 28% annualized, respectively.

Several members voiced their endorsement for the Frank/Dodd bill that is currently in Congress. One member noted that while none of these bills are perfect, that this proposal is certainly focused on the key problem which is encouraging lenders and borrowers to find an alternative to foreclosure which serves few interests and might in and of itself fuel housing price declines and create additional defaults.

While few members argued against the “intent” of the proposal, several people articulated their concerns that embedded in such proposals are many unintended consequences. One such concern that otherwise able borrowers would be incentivised to default to capture the same benefit as the borrowers targeted by this legislation.

Several members noted that one of the key issues to encourage servicers to modify loans in hopes of preventing default and foreclosures is the legal liability associated with these actions given the disparate interests embedded in a securitized loan. A number of

members recommended that Congress indemnify the servicers while at least one other questioned the long-term impact of what is essentially a repudiation of contract law.

In the final section of the charge, the Committee considered the composition of marketable financing for the April-June Quarter to refund the \$74.0 billion of privately held notes and bonds maturing May 15, 2008, the Committee recommended a \$15 billion 10-year note due May 15, 2018 and a \$7 billion reopening of the 30-year bond due February 15, 2038. For the remainder of the quarter, the Committee recommends a \$30 billion 2-year note in May and \$31 billion 2-note in June, \$20 billion 5-year notes in May and June, and a \$10 billion re-opening of the 10-year note in June.

□

For the July-September quarter, the Committee recommended financing as found in the attached table. Relevant figures included three 2-year note issuances monthly, three 5-year note issuances monthly, a 10-year note issuance in August followed by a re-opening in September, a 30-year bond in August, as well as a 10-year TIPs note in July, and a 20-year TIPs re-opening later that same month.

Respectfully submitted,

Keith T. Anderson
Chairman

Rick Rieder
Vice Chairman

Attachments (2)
Table Q2 08
Table Q3 08